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Stryker Corporation SYK

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by [Julie Stralow, CFA](#)

Thesis 05-21-2010

Stryker excels in several orthopedic and medical equipment niches. We expect the firm to continue launching innovative new products to help expand these niches and its own profitability even further in the long run.

Around 60% of Stryker's revenue comes from orthopedic implants, where the firm is a top-tier provider of knees and hips and a growing provider of spinal implants. We think the orthopedic industry is very attractive because of its high barriers to success, and Stryker should be a key beneficiary of growth in surgical procedures to repair joints.

Demographic trends in developed countries should drive solid volume growth for the industry, as their populations age and suffer from the consequences of obesity trends. Although we are enthusiastic about orthopedic volume growth prospects, some uncertainty exists regarding ongoing pricing levels because of U.S. reform initiatives and growing national budget deficits worldwide, which could cause some key payers to scrutinize medical costs more intensely. However, even in our most dire scenarios, we

Morningstar Rating
★★★★

Stock Price

As of 05-21-2010
\$52.70

Fair Value Estimate

\$72.00

Consider Buying

\$50.40

Consider Selling

\$100.80

Fair Value Uncertainty

Medium

Economic Moat

Wide

Stewardship Grade

C

Bulls Say

think Stryker's returns on invested capital should remain higher than capital costs, primarily because of the positive characteristics of the orthopedic implant market.

The balance of Stryker's sales comes from tools and equipment to outfit surgical suites and regular hospital rooms. Stryker is particularly prolific in operating room products, including cutting tools, medical video equipment, and irrigation devices. These tools often complement its orthopedic devices and greatly improve the efficiency of surgical procedures. Stryker is even a top provider of medical beds and emergency equipment, such as stretchers. Although not as fundamentally attractive as implants and somewhat susceptible to economic cycles, these offerings often expand at faster rates than Stryker's orthopedic implant products. In the long run, we think that trend could continue, assuming the company expands as expected in international markets.

With its cash-rich balance sheet and admirable free cash-flow generation, Stryker remains in the enviable position of having many avenues to return value to shareholders. Stryker could significantly boost its dividend or repurchase shares at attractive prices to bolster investor returns with its substantial cash resources. Also, depending on the acquisition target, Stryker could use its big cash position to invest in new technology in fast-growing niches, boosting its growth potential.

Valuation

We're keeping our fair value estimate at \$72 per share. We assume sales growth rebounds to about 11% compounded annually through 2014. Specifically, we assume the orthopedic business grows 9% compounded annually during those years, which reflects solid growth from knees and hips and acceleration in the spine business as new product candidates are launched successfully. From a low base in 2009, we assume the MedSurg business follows the growth

- Stryker's balance sheet is filled with cash. Acquisitions to accelerate growth remain a key priority, but the firm could return value to shareholders by other means, as well.
- International operations in Stryker's MedSurg segment--operating room and other medical equipment--remain relatively small and provide a key growth opportunity.
- New products could boost growth in hips (ADM-X3 and Rejuvenate) and keep growth strong in knees (OtisMed's customization system).
- By acquiring Ascent, a leading reprocessor of single-use medical instruments, Stryker aims to provide a way for hospital administrators to lower costs--an important consideration especially in an increasingly cost-conscious health-care environment.

Bears Say

- Health-care reform efforts could reduce long-term returns in Stryker's U.S. operations, which accounted for 64% of the firm's business in 2009.
- Although Stryker escaped most of the punishment when the Department of

trends of the orthopedic business with a little boost from international expansion, causing 14% compound annual growth in that segment from 2009 to 2014. Our fair value estimate also depends on operating margins staying around 23% through 2012 and then dropping to about 22% after the U.S. device tax is implemented in 2014. These factors should lead to earnings per share increasing about 11% during that period. We discount our assumptions at 9.5%.

Risk

Economic concerns have disrupted Stryker's medical equipment segment recently, and caregivers may delay purchases in this segment--especially of big ticket items--in economic downturns. Also, many highly motivated and resource-rich firms compete with Stryker. If the company does not stay near the top of the innovation curve, it risks losing customers to those rivals. In the longer term, third-party payers may need to reduce payments for procedures in order to afford the expected uptick in procedure volume. If payment cuts trickle down to Stryker and it can't make comparable cost reductions, those cuts could damage returns on invested capital.

Justice targeted knee and hip providers, it might not be so lucky in future dealings with the DOJ, which has turned its attention to a key growth area for Stryker--the spine market.

- Although all outstanding Food and Drug Administration warning letters recently were lifted, Stryker is still working on improving the quality of its manufacturing operations, and there may be more bumps along the way.

Close Competitors	TTM Sales \$Mil	Market Cap \$Mil
Stryker Corporation	6,921	20,728
* <u>Johnson & Johnson</u>	62,502	167,167
* <u>Smith & Nephew PLC</u>	3,902	8,527
* <u>Zimmer Holdings, Inc.</u>	4,166	11,402

* Morningstar Analyst Report Available

Data as of 03-31-10

Strategy

Stryker hopes to arm hospitals and surgeons with the tools needed to successfully treat patients. Its broad product set

includes orthopedic implants, operating room equipment, and medical furniture. By interacting with many departments in the hospital, Stryker aims to become a top supplier to medical caregivers. It also aims to acquire new businesses to ramp up growth and diversify sales.

Management & Stewardship

Although we think Stryker's stewards employ fair practices, outside shareholders should be aware of how little control they may have on Stryker's strategic direction. Stephen MacMillan heads the firm's executive team and board, which we think remains insulated. Even though the majority of the board pass U.S. independence standards; we think the average tenure on the board, a director's consulting relationship with Stryker, and the founding family's board seat and voting power override that litmus test. Because of those factors, the board's interests may not necessarily be naturally aligned with most shareholders' interests. Also, though we're glad variable compensation, such as bonuses and stock-related rewards, make up the vast majority of executive compensation, we'd prefer to see those rewards based on returns on invested capital or free cash flow rather than earnings per share, which can be easily manipulated and may not be a true measure of value creation. We do applaud Stryker's disclosure surrounding compensation and financial performance, however, and we find Stryker's annual orthopedic market report especially valuable.

Profile

Stryker develops, manufactures, and markets medical devices and equipment for use primarily in orthopedic procedures. The firm generates most of its revenue from reconstructive implants, such as knees and hips, but serves a variety of other orthopedic niches, including spine. Stryker also offers a wide range of operating room equipment and tools used for orthopedic and other procedures. Hospital beds and stretchers account for a portion of Stryker's sales,

too.

Growth

We think new product launches and procedure growth should help Stryker grow 11% compounded annually through 2014. Acquisitions could add to that rate.

Profitability

Through major cost-control efforts, operating margins in recent quarters have risen past our long-term assumption of 22%. We think reform initiatives and increasing regulatory requirements could constrain Stryker's margins in the long run.

Financial Health

Stryker ended March with \$2.9 billion in net cash. With those substantial resources and ongoing cash flow, we expect it to return more value to shareholders or make acquisitions in fast-growing niches.

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